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STATE FOR EUR/SE, EB/IFD/OMA AND E
TREASURY FOR OASIA - MILLS, GUNARATNE AND LEICHTER
STATE PASS USTR - NOVELLI AND BIRDSEY

E.O. 12958: N/A
TAGS: ECON EFIN PREL TU
SUBJECT: TURKISH MARKETS RALLY; TREASURY COMMENTS ON
INTEREST RATES AND DEBT IN 2003

Sensitive but Unclassified. Not for internet distribution.

¶1. (SBU) Summary: The post-election rally in Turkish markets continued on November 5, with trading volumes in both stock and T-bill markets setting records for 2002. T-bill rates dropped about seven percentage points to close at 57.5 percent in annual compounded terms; the stock market is up 17 percent over the past two days. Treasury's main debt expert, however, is concerned that the November 5 decline in interest rates is too sharp to be sustainable. He also gave us the current 2003 debt financing projections (updated from the Treasury's September presentation given in Washington.) End Summary.

Market Rally Continues

¶2. (U) Investment poured into the local Turkish T-bill and stock markets on November 5. Trading volumes hit records not seen since early 2000: $1.1 billion in the stock market (normal day trading volume less than $200 million); $885 million in the T-bill market, normal day trading volume about $200 million). In addition, the Treasury auctioned two T-bills November 5, ahead of $3.5 billion in redemptions on November 6 and raised another $2 billion.

¶3. (U) The result of the rally after two dates is that the stock market has risen 17 percent (including 10 percent November 5) and the benchmark July 2 T-bill has dropped seven percentage points, closing today at 57/5 percent in annual compounded terms.

¶4. (U) The composition of the inflows into the two markets is different. The stock market is being driven to date by retail Turkish demand. One brokerage analyst - David Edgerly of Garanti Securities - believes pro-Islamist AK supporters account for much of the buying. They traditionally play a big role in the stock market (but not in bonds). The T-bill market is seeing some large foreign inflows from hedge funds, as well as Turkish banks upping their positions.

Treasury Expert Worries:
Rates Decline Too Sharp To Be Sustainable

¶5. (SBU) Despite the successful auctions, Treasury's main debt expert, Deputy DG for Public Finance Volkan Taskin, was nevertheless in a worried mood when we visited him November
¶5. "This sharp drop raises concerns about sustainability of interest rates at these levels; it reminds me of early 2000 (when interest rates dropped too quickly and then veered upwards again). Nothing has actually happened to sustain these levels, all we have are some announcements from AK." Taskin would rather see a more gradual decline; the November 5 declines could in his view lead to further unsettling volatility in the domestic debt market.

¶6. (SBU) Taskin's main worry is with the 2003 budget that the new GOT will start to put together soon. If AK is overly encouraged by the short-term reaction to their victory in the T-bill market, they may conclude they have room to relax the primary surplus target of 6.5 percent of GNP. If they do that, then they'll get a negative reaction that will unsettle the markets, he opines.

¶7. (SBU) We asked Taskin about Treasury's latest debt

financing projections for 2003, which shows total debt servicing of $77 billion (broken down into $66 billion in domestic debt service and $11 billion in external debt service; the domestic portion is further broken down into $47 billion in debt service to the market and $19 billion in debt service to public sector institutions, primarily state banks). This $77 billion will be financed as follows:

-- $ 57 billion from domestic borrowing;
-- $ 10.3 billion from primary budget surplus;
-- $ 3.9 billion from IFI financing ($2.7 billion from IMF, $1.2 billion from World Bank);
-- $ 5.5 billion from external borrowing from markets ($4.5 billion in Eurobonds, $ 1 billion in project financing);
-- $ 0.3 billion from Treasury's cash account.

¶8. (SBU) The $77 billion financing need assumes average nominal interest rates in 2003 of 47 percent, starting at 60 percent in January (note: rates as of today were under this) and declining to 36 percent by December 2003. Average maturity of TL fixed rate bills is projected at 8.6 months. The projected $57 billion in domestic borrowing results in a total debt roll-over rate of 87 percent (versus the projected 2002 year-end rate of 78 percent), and a market roll-over rate of 95 percent (versus projected 2002 year-end rate of 96 percent and year to date market roll-over rate of 103 percent).

¶9. (SBU) Asked why privatization receipts were not included in next year's debt financing projections, Taskin said the Privatization Administration was still targeting $1.7 billion in privatization receipts, but that none of it would go to the budget. All of it would stay in the PA to help off the PA's existing debt to Halk Bank (used to meet PA's large payroll expenses for the state companies in its portfolio).

¶10. (SBU) Taskin further explained that Treasury's current cash account of about TL 5 quadrillion (about $3 billion) would be largely used up over next two months in redeeming debt as it comes due. The new borrowing law enacted in 2002 limits Treasury's ability to borrow under current budget deficit conditions - they have to use cash on hand to pay off debt.

¶11. (SBU) Taskin is confident about Treasury's ability to meet the 2003 debt servicing needs - though $77 billion is an unprecedented amount of debt for Turkey to service in one year. He notes two developments: first, about one quarter of next year's debt service is to public institutions and thus presumably easily rolled over; second, the domestic debt market has deepened considerably and is no longer controlled by a handful of Turkish banks. Changes in the tax law in fall 2001 favor holding T-bills versus keeping cash in the overnight money markets. Today, nearly 40 percent of the traded domestic debt is held by individuals, who per Taskin tend to hold it to maturity (in the recent past, individuals held only about 10 percent of debt and banks held the vast majority).

¶12. (SBU) Taskin concluded that the $77 billion debt service figure changes day by day, and the November 5 drop in interest rates will result in new projections. It's still too early to accurately predict next year's financing demands. The biggest single challenge for Taskin is lengthening debt maturity. In times of crisis, he is basically forced to roll-over Turkey's entire domestic debt stock every three to four months. Getting beyond crisis means to him lengthening the debt maturity to beyond one year.
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